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SUBJECT: Canadian Banks Still Weathering North American Credit Crunch

REF: (A) 07 Toronto 430 (B) 07 Toronto 422

Sensitive But Unclassified -- protect accordingly.

¶1. (SBU) Summary: Canada's non-bank sponsored (third party) asset-backed commercial paper (ABCP) market will remain frozen until April or May while the Crawford Committee, charged with the market's restructuring, secures financial backing from Canadian banks. Canadian banks reported their first combined profit decline in almost six years this quarter due to writedowns from Canadian and U.S. investment vehicles that include structured investment vehicles (SIVs) and ABCP, as well as bad loans. Two of Canada's big five banks, the Canadian Imperial Bank of Commerce (CIBC) and the Bank of Montreal (BMO), announced significant writedowns; CIBC due to exposure to the U.S. sub-prime mortgage market and BMO as a result of heavy exposure to Canada's ABCP market (ref (A)). Two of the others, Royal Bank of Canada (RBC) and Bank of Nova Scotia (Scotiabank), took smaller charges. Only Toronto Dominion Bank (TD), Canada's second largest bank and the only one of the five without heavy exposure to the U.S. sub-prime market, reported higher quarterly profits. When TD and RBC finish sorting out their bad credit exposures in coming months, they may seek to expand their U.S. operations, capitalizing on the strong Canadian dollar and the relative weakness of U.S. bank stock prices. End Summary.

Canadian Asset-Backed Commercial Paper

¶2. (U) Canada's C$30 billion third party (non-bank sponsored) asset-backed commercial paper (ABCP) market will reportedly remain frozen until at least the end of April. The Crawford Committee, which has been charged with restructuring the market, is still working with financial institutions to unravel and value the involved assets. In February, RBC, BMO, CIBC, and Scotiabank, along with the National Bank of Canada (the sixth largest Canadian bank) officially agreed to finance a C$14 billion backup line of credit to support replacement of the ABCP with a newly created issue of longer term bonds. BMO is rumored to be wavering on its financial backing of the restructuring, however, due to troubles with its own bank-sponsored ABCP. TD Bank has made it clear that since TD was not involved in the ABCP market, TD would not assume ABCP-related restructuring risk. (Note: The Canadian bank-sponsored ABCP market, which includes about 29 trusts worth about C$80 billion, remains active, but is on shaky ground.)

¶3. (U) The third party ABCP market restructuring agreement will swap the current commercial paper, which matures in less than one year, for new bonds with an average maturity of 7 years. The new bonds

will be backed by the line of credit or margin lending facility supplied by the banks. If the margin facility is drawn upon, facility lenders will become senior creditors with priority over bond holders.

CIBC - The Biggest Loser

¶4. (U) CIBC, Canada's fifth largest bank, reported its second-biggest quarterly loss ever - C$1.456 billion (US$ 1.49 billion), after writing down C$3.49 billion pre-tax on investments tied to U.S. sub-prime mortgages. At the end of 2007, CIBC revealed that its exposure to the U.S. sub-prime mortgage market was significantly higher than Canada's other big banks. CIBC World Markets invested more than US$10 billion in the U.S. sub-prime real estate market, US$3.5 billion of which was hedged with troubled New York-based monoline insurer ACA Financial (ACA).

¶5. (U) CIBC's writedowns include C$2.28 billion related to its exposure to ACA; a C$626 million charge on exposure to other financial guarantors; C$473 million of paper losses on securities (collateralized debt obligations (CDOs) and residential mortgage-backed securities (RMBS)) tied to the U.S. mortgage market; and a C$108 million loss on the sale of some of the bank's U.S. investment banking business to Toronto-based Oppenheimer Holdings Inc. CIBC retains its U.S. wholesale businesses, including real estate finance, equity commodity structured products, merchant banking, and oil and gas advisory services, as well as the rest of its U.S. debt-capital-markets, Asia and U.K. businesses.

¶6. (U) CIBC has had the worst performing stock among Canada's five biggest banks over the past year. To improve its balance sheet, in January, CIBC sold C$2.9 billion of shares to blue chip investors,

including Manulife Financial, Caisse de dptt et placement du Qubec, Hong Kong billionaire Li Ka-Shing, and OMERS (the investment arm of Ontario's municipal employees pension fund). Prior to its Q1 2008 writedown, the bank had written down more than C$3 billion worth of exposure to the U.S. sub-prime mortgage market, surpassing US$2.4 billion in writedowns it took to settle Enron-related troubles in 2005.

BMO Still Unraveling Its ABCP Involvement

¶7. (U) Meanwhile, BMO, Canada's fourth largest bank, announced it would writedown C$490 million pre-tax (C$325 million after tax) in Q1 2008, further fallout from last year's credit market turbulence. About C$160 million of BMO's writedowns relate to transactions hedged with ACA, which has also affected CIBC and RBC. The balance of BMO's writedowns include C$175 million related to trading and structured credit losses, and C$130 million for its ABCP holdings issued by BMO-sponsored Apex/Sitka Trust (in addition to the C$80 million BMO wrote down on this investment in Q4 2007). Another C$25 million of the first quarter writedowns come from capital notes in the bank's two London, England-based structured investment vehicles (SIVs), Links Finance Corp. and Parkland Corp. The bank also increased its provision for credit losses by C$60 million. BMO, one of Canada's biggest players in the ABCP market, already wrote-down C$787 million last year. In the past week alone, BMO lost C$5.2 billion in market value as its stock dropped C$10.38 or nearly 20%.

¶8. (U) On March 4, BMO reported Q1 2008 earnings of C$255 million in the three months ending January 31, a 27% decrease from Q1 2007. The bank's pre-tax charges for Q1 amounted to C$548 million. BMO expects to miss annual profit targets due to potential further writedowns next quarter. BMO is negotiating to restructure the two ABCP trusts it sponsors -- Apex and Sitka Trusts, which are not included in the ABCP market restructuring being undertaken by the Crawford Committee. If no deal is reached, the bank expects to take an additional C$500 million writedown next quarter. Canada's rating agency, DBRS, downgraded Apex from AAA to CCC -- junk bond territory

-- on February 28.

¶9. (U) BMO has also committed to provide liquidity support facilities of C$10.2 billion to its U.S.-sponsored ABCP conduit, Chicago-based Fairway Finance Co. This commitment prompted BMO's share price to fall 6.7% on the Toronto Stock Exchange (TSX) on March 6. The bank has also committed to provide more than C$12 billion in backup support to its two struggling UK-based SIVs. Income generated from BMO's retail and commercial banking segments in the U.S. (P&C U.S.), which operate under Chicago-based Harris Bank, declined C$3 million or 9.5% in Q1 2008 compared with the same quarter last year. Revenue in this segment rose US$19 million or 9.9%, largely due to the inclusion of US$12 million in revenue from Indianapolis, Indiana-based First National Bank & Trust (FNBT), acquired by BMO in January 2007. P&C U.S. does not sell sub-prime mortgages, and has minimal retail exposure to sub-prime mortgage instruments. On February 28, 2008, BMO, and its U.S. subsidiary Harris, completed the acquisitions of Ozaukee Bank (for approximately US$190 million in stock), and Merchants and Manufacturers Bancorporation, Inc. (for approximately US$137.2 million in cash), both based in Wisconsin. The transactions had been announced in 2007.

Scotiabank's Earnings Weaker Than Expected

¶10. (U) On March 4, Bank of Nova Scotia (Scotiabank), Canada's third largest bank, also released weaker than expected Q1 2008 earnings of C$835 million, down 18% from last year. While the bank's domestic and international banking divisions grew, the bank's capital markets division took a hit from global financial market volatility, leading to a C$158 million pre-tax writedown on its holdings in collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), SIVs; and C$44 million for non-bank ABCP. The bank also recorded a charge of C$80 million related to exposure to an unnamed bond insurer. In Q4 2007, Scotiabank incurred pre-tax losses of C$191 million on structured credit instruments. Scotiabank has no retail banking operations in the U.S., except for Puerto Rico

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Royal Bank of Canada Records Declining Net Income

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¶11. (U) RBC, Canada's biggest bank, announced February 29 that its Q1 2008 net income dropped to C$1.245 billion, down 17% from record earnings in Q1 2007. The results include a C$187 million after-tax (C$430 million before-tax) writedown in its capital markets group related to U.S. sub-prime exposure, U.S. ABCP, bad loans in its U.S. retail banking operation over the last year, and a C$45 million reduction in earnings on U.S. dollar-based and British pound-based operations, due to the appreciation of the Canadian dollar against the U.S. dollar and British pound.

¶12. (U) RBC's Capital Markets division wrote down C$288 million due to its exposure to U.S. sub-prime RMBS and collateralized debt obligations of asset-backed securities, including a C$201 million writedown on credit default swaps (CDS) with monoline insurers, including C$122 million related to bond insurer ACA Financial Guaranty Corp (ACA) and C$79 million related to a subsidiary of Armonk, New York-based MBIA Inc. (MBIA), a monoline insurance provider. The remaining C$87 million in writedowns relate to the bank's U.S. sub-prime and ABCP holdings. The bank already recorded a C$357 million writedown in Q4 2007 that was reportedly due to the inability of an unnamed U.S. bond insurance company to honor its guarantees of RBC's sub-prime mortgage investments. Despite its writedowns, RBC expects fiscal-year earnings growth of 7-10%, and a return on equity of more than 20% in 2008.

¶13. (U) RBC also announced February 14 that it will purchase Washington, D.C.-based wealth manager Ferris, Baker Watts Inc. (FBW). RBC's Minneapolis-based wealth management unit, RBC Dain Rauscher Inc., will acquire privately held FBW for an undisclosed

price, expanding RBC's presence in the Eastern, Midwest, and Mid-Atlantic regions.

Toronto Dominion Bank Profits Up

¶14. (U) While rivals reported quarterly losses and declining profits, TD, Canada's second largest bank, reported Q1 2008 profits of C$970 million, up 5.3% from a year earlier. TD's Q1 results reflected the strength of its retail businesses in both Canada and the U.S. Earnings from U.S. consumer banking at TD Banknorth doubled in Q1 from last year, to C$127 million (Note: TD Banknorth became a wholly-owned subsidiary of TD on April 27, 2007).

¶15. (U) Earnings from TD's investment banking arm, Wholesale Banking, dropped 17% from a year ago to C$163 million, due to lower trading revenue and a slump in mergers. TD's Canadian consumer banking operations, TD Canada Trust, boosted earnings by 10% to C$598 million, thanks to increased real-estate lending and credit card profits. Earnings from asset management, which includes the bank's 40% stake in Omaha, Nebraska-based TD Ameritrade Holding Corp., climbed 16% to C$216 million. TD is the only major Canadian bank that was not involved in the third party ABCP market, and had minimal exposure to U.S.-based credit problems. Of Canada's big five banks, TD is the only bank that has refused to support the restructuring of the still frozen C$30 billion Canadian ABCP market.

¶16. (SBU) Comment: The IMF reported in February that Canada's banking system is among the world's most highly developed, and is well-positioned to withstand a broad range of shocks, including turmoil stemming from the U.S. sub-prime mortgage meltdown. With BMO and CIBC share prices hit particularly hard during the first week of March, the Canadian banking sector overall lost 10% of its market value on the Toronto Stock Exchange. After the current credit turmoil subsides, Canadian banks are expected to be significantly more risk averse. When they finish sorting out their bad credit exposures in the coming months, however, the big Canadian banks may well seek to capitalize on the strong Canadian dollar (ref (B)) and the relative weakness of U.S. bank stock prices to expand their U.S. financial sector operations. RBC and TD Bank are the most likely candidates to buy more U.S. banks. TD Bank's market capitalization (US$46.99 billion on March 5) is now nearly equal to that of Merrill Lynch (US$47.91 billion on March 5), though for Q1 reporting purposes TD's market cap was C$48.9 billion, making it larger than Merrill Lynch. RBC, with a market capitalization of US$62.46 billion on March 5, is bigger than Morgan Stanley in terms of market capitalization (US$44.81 billion). We do not expect Scotiabank to enter into retail banking in the U.S., nor that BMO or CIBC will be able in the near term to significantly expand their U.S. presence. End Comment.

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